



March 21, 2006

Mr. Kirk Rodgers  
Mid-Pacific Regional Director  
Bureau of Reclamation  
2800 Cottage Way  
Sacramento, CA 95825

Dear Mr. Rodgers:

The Central Valley Project Water Association and the Northern California Power Agency have a long history of working effectively with Reclamation to collaboratively resolve complex, and occasionally contentious, issues affecting Central Valley Project (CVP) water and power contractors (Contractors). It is in this spirit that we write to you today to initiate a process to address some of our long-standing concerns about Reclamation's current CVP cost allocation structure.

In response to the requirements of Public Law 99-546 (COA), Reclamation issued its May 2001 Central Valley Project Cost Allocation Study (Report). Reclamation has acknowledged that the Report did not constitute a new cost allocation study based on estimates of project benefits or alternatives due, in part, to the significant resources that would have been required to conduct such a study. Instead, the Report chose to continue using the cost allocation formulae derived from an update implemented in 1975.

The Contractors contend that the Report does not meet the requirements of the COA and continue to believe that the cost allocation structure currently in use results in inappropriate allocations of costs to the various CVP purposes. We met with you in January 2005 to express our concern that Reclamation had not completed a new CVP cost allocation study in compliance with the COA. After examining the issues related to making a new cost allocation study, we are not requesting the initiation of a new cost allocation at this time. Instead, we are requesting the development of an administrative action to ameliorate the current cost allocation flaws through two targeted steps:

1. **Return to the 1970 Separable Cost Remaining Benefit (SCRB) cost allocation factors.** A short-form allocation was completed in 1975 to update the 1970 cost allocation study, but the benefits and alternative costs for several of the project purposes were not updated in that short-form update. The principles of analyzing and treating all project purposes

on a comparable basis, which is inherent in a SCRB allocation, were compromised in the 1975 short-form update. The 1975 update also incorporated unrealistic assumptions pertaining to both inflation factors and power costs. Finally, documentation available to validate the conclusions of the 1975 update is incomplete and inadequate, consisting of only 20 pages.

2. **Incorporate cost allocation adjustments required by the COA to reflect changes in CVP operations necessary to meet the State's water quality standards.** The COA establishes criteria for allocating costs associated with meeting State water quality objectives among all CVP project purposes. **The Contractors' understanding of this legislation is that this language is inclusive of both the resource cost, water, and the financial costs associated with the resultant re-operation of the CVP.** In the absence of a new SCRB, the Contractors believe that the most appropriate way to implement the COA requirement is to adjust the water supply sub-allocation to reflect the changes in operations necessary to meet the State water quality objectives.

These two steps are discussed further in the enclosed **Central Valley Project Cost Allocation Administrative Proposal**.

Your consideration of this matter is appreciated. We would also appreciate your assistance in implementing this proposal within a timeframe that allows its incorporation into the 2007 water and power rates. Our agencies, along with the water and power contractors we represent, are willing to work with Reclamation to resolve technical issues and accomplish these adjustments.

We are confident that Reclamation has the administrative authority to implement these adjustments. Moreover, we believe that Reclamation is compelled to act in this instance, which entails one adjustment to correct the impacts of a severely flawed update by returning to the 1970 cost allocation study and one adjustment to incorporate a specific legislative requirement.

We look forward to working with you and your staff to resolve these issues.

Sincerely,



Robert F. Stackhouse  
Executive Director  
Central Valley Project Water Association



James H. Pope  
General Manager  
Northern California Power Agency

Enclosure



# **Central Valley Project Cost Allocation Administrative Proposal March 21, 2005**

In response to the requirements of Public Law 99-546 (COA Legislation), Reclamation issued its May 2001 Central Valley Project Cost Allocation Study (Report). Reclamation has acknowledged that the Report did not constitute a new cost allocation study based on estimates of project benefits or alternatives due, in part, to the significant resources that would have been required to conduct such a study. Instead, the Report chose to continue using the cost allocation formulae derived from an update implemented in 1975.

The Contractors contend that the Report does not meet the requirements of the COA Legislation and continue to believe that the cost allocation structure currently in use results in inappropriate allocations of costs to the various CVP purposes. After examining the issues related to making a new cost allocation study, we have developed this administrative proposal that addresses the inadequacies of the current cost allocation structure through the two targeted adjustments detailed below.

## **1. Return to the 1970 SCRB Factors**

The last complete cost allocation study for the CVP was implemented in 1970. In the 1970 study, the benefits and single-purpose alternative costs needed for a Separable Cost Remaining Benefits (SCRB) allocation were calculated for each CVP purpose. In the 1975 short-form update, two main changes were incorporated:

- The type of power plant used as a basis to determine the benefits and single-purpose alternatives for the Power project purpose was changed from the fossil fuel plant used in the 1970 allocation to a significantly more expensive nuclear plant.
- The alternative cost for the Water Supply project purpose was indexed forward from 1968 to the prevailing high inflation levels of 1975. Benefits, alternative costs, and inflation indexing for most other CVP purposes remained unchanged.

Records indicated that neither the benefits nor the single-purpose alternative costs for Flood Control were recalculated in the 1975 short-form update. Furthermore, the Flood Control project purpose was not indexed forward from 1968 to 1975. The Flood Control benefits incorporated in 1975 were almost unchanged from the data used in 1970.

A summary of the impacts resulting from this flawed update are illustrated below.

**Comparison of CVP Base I Allocation Factors  
From the 1970 and 1975 Studies**

	Wtr Supply	Power	F&WL	Recreation	Flood Ctrl	Navigation
1970 Study	54.18	5.63	1.92	0.00	36.12	2.15
1975 Study	55.79	21.81	0.00	0.00	20.49	1.91
Increase	01.61	16.18	(1.92)	0.00	(15.63)	(0.24)
(Decrease)	3%	287%	(100%)	N/A	(43%)	(11%)

When the 1975 short-form update was performed, it was anticipated that another complete cost allocation would be conducted in 1980 that would allocate CVP costs based upon the benefits and alternative costs for all the CVP project purposes. Subsequent updates have not occurred, however, and the multipurpose allocation factors developed in the 1975 short-form update have continued to be used through 2005. Imposing such a significant shift in CVP costs from non-reimbursable to reimbursable project purposes and keeping those allocation factors in place for 30 years without conducting new benefit and alternative cost studies for Flood Control and other non-reimbursable project purposes has perpetuated the allocation of costs based on a flawed model.

The allocation factors in the 1975 short-form update incorporate the following significant flaws:

1. The 1975 short-form update used nuclear power to determine the value for CVP energy because it was thought to be the new energy technology. As the 1973-1974 Arab Oil Embargo progressed, alarming predictions became widespread regarding extreme increases in the cost of fossil fuel. This led to the use of a nuclear power facility as the single-purpose alternative in calculating power benefits. Using nuclear power as the alternative significantly increased the cost allocated to power. However, both the prediction of nuclear plants as the new technology and the projections for significantly escalating fossil fuel prices proved inaccurate.
2. The 1975 short-form update did not perform new studies of benefits for all project purposes. The Power, Fish & Wildlife, and Navigation benefits were updated, while benefits calculations for Recreation, Water Supply, and Flood Control were left at 1970 values. Recreation benefits were left at zero. Water Supply benefits were unchanged because these benefits were assumed to exceed single-purpose alternative costs, but there is no indication that the single-purpose alternative was re-evaluated. The Flood Control benefits were not updated at all. The Corps of Engineers (COE) acknowledged during the 1975 study that "It appears that the effect of the new hydrology would be to increase the indicated average annual



benefits". However, the COE never performed this study due to "concurrent substantive increases in the complexity of such studies".

3. The 1975 short-form update utilized inconsistent indexing for inflation. The inflation index data utilized to derive the Water Supply allocation factor was adjusted forward from 1968 levels to 1975 levels, while the inflation data for most of the other project purposes was left at the 1970 levels. The indexing adjustment raised the benefits attributed to the Water Supply project purpose from \$1.4 billion in 1970 to \$2.5 billion in 1975, an increase of more than 75%.
4. The 1975 short-form update was intended to be used only to allocate CVP costs for a short period of time to reflect the spike in the 1973 and 1974 energy prices. Another SCRB was anticipated in 1980 to completely analyze the benefits and alternative costs for each project purpose. The 1980 SCRB never occurred and no complete allocation has been performed since 1970.

We must stress that available documentation to support the 1975 short-form update is incomplete and inadequate. There are only 20 pages of supporting documents for the entire 1975 allocation, whereas the 1970 allocation is well documented and was performed in accordance with established cost allocation principles. This limited documentation makes reviewing and justifying the process used for the 1975 allocation impossible while the rationale and cost information for the 1970 cost allocation can be substantiated. Using the 1975 factors is not supportable due to the lack of records regarding basic cost inputs and calculations used to determine the allocation factors. There is no record of how these cost allocation factors were derived, which means that there is no way to verify that these factors were accurately calculated.

**For the above reasons, the Contractors request that Reclamation revert to using the supportable and more appropriate 1970 cost allocation factors.**

## **2. Incorporate COA Water Quality Requirements**

A component of the October 27, 1986 COA Legislation authorized and directed the Secretary of the Interior to operate the CVP in conformity with the State of California's water quality objectives established for the San Francisco Bay and Sacramento – San Joaquin Rivers Delta Estuary, unless the Secretary found that such operations conflicted with other CVP related Congressional directives.

Since enactment of the COA Legislation no such conflict has been identified by the Secretary and Reclamation has provided annually varying quantiles of water to meet the water quality objectives. The variability through the years has been



generally governed by the standards in place and the hydrologic cycle. Initially, Reclamation was to meet the standards promulgated by the State Water Resources Control Board's (SWRCB) 1978 "Decision in Furtherance of Jurisdiction Reserved in Permits of the United States Bureau of Reclamation for the Federal Central Valley Project and Department of Water Resources for the State Water Project" (D1485). Though D1485 was the specific subject of the COA Legislation, Congress anticipated additional and more stringent standards in the future.

In 1995, the SWRCB adopted the Water Quality Control Plan for the San Francisco Bay and Sacramento – San Joaquin Delta Estuary (Control Plan), which established additional limitations on operations of the CVP that were intended to protect and enhance fish and wildlife uses, including achieving the narrative anadromous fish doubling goal. The Control Plan was formally implemented by the SWRCB's 2000 "Decision Implementing Flow Objectives for The Bay-Delta Estuary, Approving a Petition to Change Points of Diversion of the Central Valley Project and the State Water Project in the Southern Delta, and Approving a Petition to Change Places of Use and Purposes of Use of the Central Valley Project" (D1641). Current modeling suggests the stricter standards set forth in D1641 resulted in an additional average annual delivery impact to the CVP of approximately 100,000 acre-feet. CVP water contractors estimate the total average annual water supply cost for meeting the State's Bay-Delta estuary water quality objectives is now at 400,000 acre-feet.

In the COA Legislation, Congress recognized the financial consequence of complying with the State's water quality standards by calling for the costs of meeting the D1485 standard to be allocated among all CVP purposes, with the portion delegated to the water and power purposes being reimbursable. Furthermore, Congress chose to limit the financial exposure of CVP Contractors for anticipated increases in water quality demands by declaring those costs above the D1485 standard to be non-reimbursable.

Reclamation has previously indicated that compliance with the D1485 standards resulted in no "cost" to the CVP as the ability to provide full water deliveries to long-term contractors was unaffected. This claim is based on the results of hydrologic simulations conducted nearly twenty-years ago and an interpretation of "cost" with which CVP water contractors disagree. On the first point, CVP water contractors' review of various modeling runs conducted over the last few years indicate that there is indeed a delivery impact to the CVP as a result of Reclamation's compliance with D1485 water quality standards. On the second point, the COA refers to "costs associated with providing Central Valley project water" shall be allocated among the CVP purposes. CVP water contractors believe this language is inclusive of both the resource cost, water supply, and the financial costs associated with the resultant re-operation of the CVP.